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Forbes

HOW REAL ARE THOSE BLUE CHIP EARNINGS?

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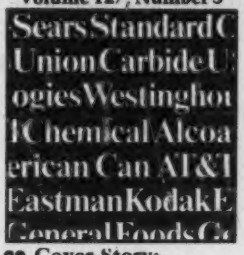

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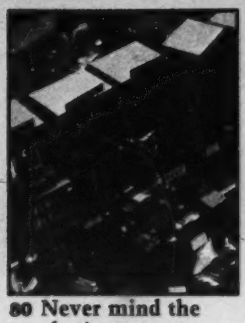

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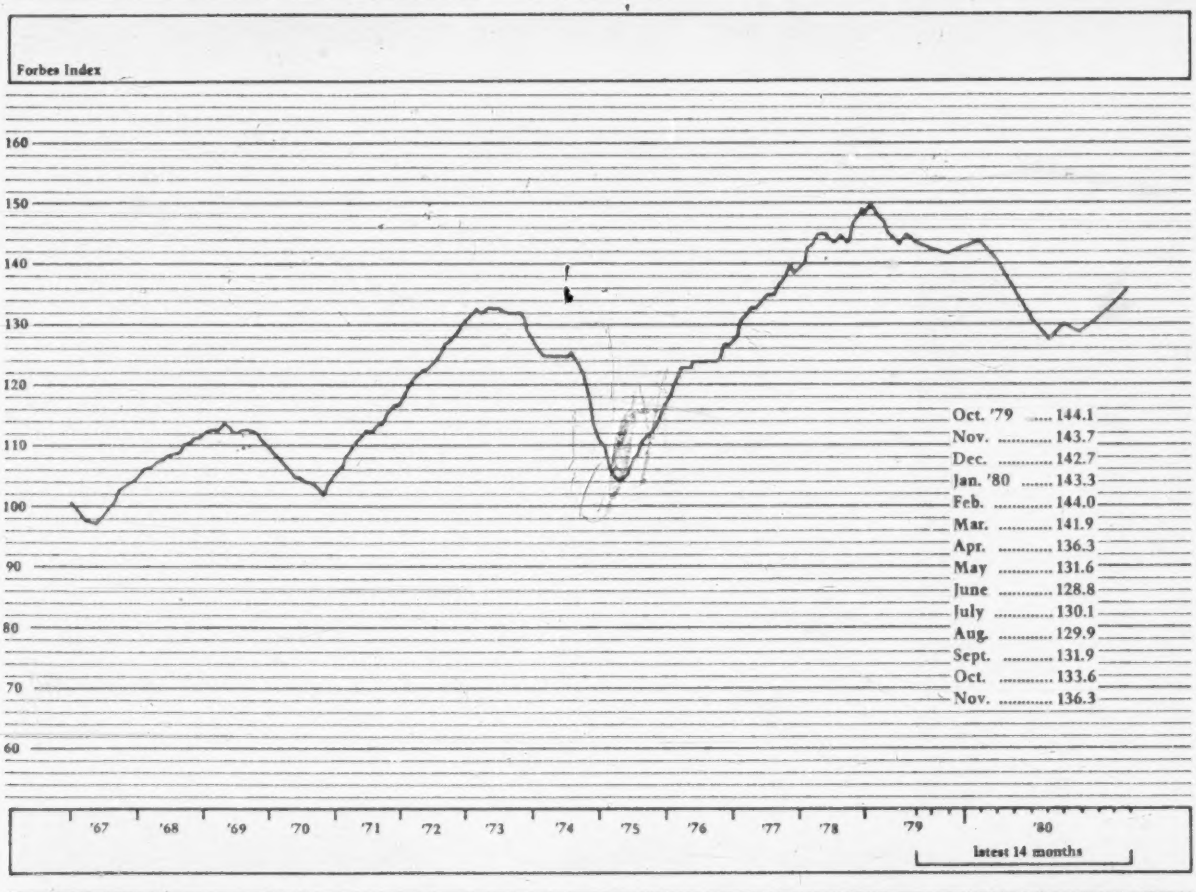
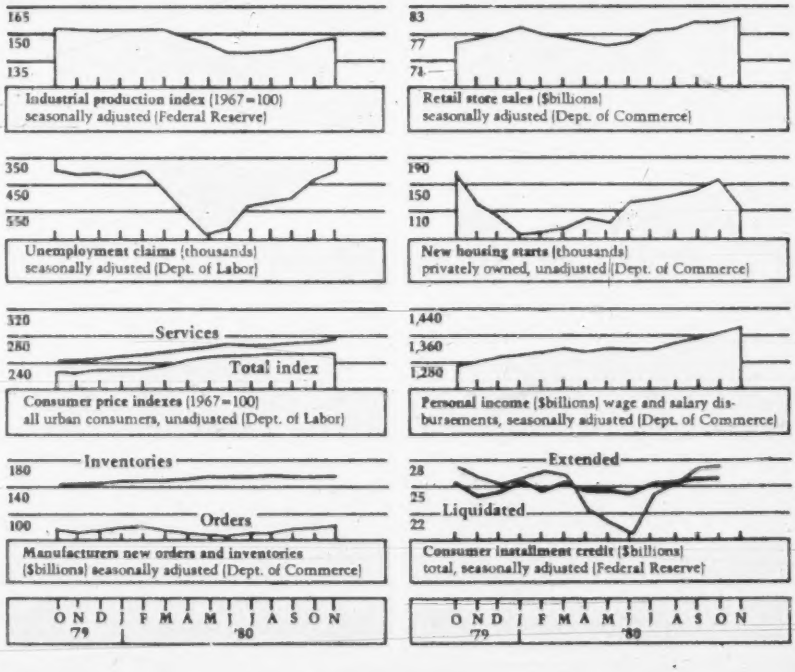
The Forbes Index



The Forbes Index Components

If there's a double dip in the economy's future, it hasn't hit the Forbes Index yet. In the current reporting period, the only component to show a major decline is housing starts, which were off by nearly 30%. By contrast, other indicators, especially industrial production and retail sales, are currently showing healthy gains.



The FORBES Index is a measure of U.S. economic activity composed of eight equally weighted elements:

Total industrial production

New claims for unemployment compensation

The cost of services relative to all consumer prices

The level of new orders for durable goods compared with manufacturers' inventories

Total retail sales

New housing starts

Personal income

The change in the amount of consumer installment debt outstanding

To measure these eight elements, FORBES monitors 11 series of U.S. government data. The last 14 months' data for each series is presented at right.

Though my bottom line is black, I am flat upon my back,
My cash flows out and customers pay slow.
The growth of my receivables is almost unbelievable;
The result is certain—unremitting woe!
And I hear the banker utter an ominous low mutter,
"Watch cash flow."

—Herbert S. Bailey Jr., with apologies to Edgar Allan Poe's "The Raven"

Are more Chryslers in the offing?

By Richard Greene

WE'RE PROBABLY COMING TO AN END of what could be called "The Time of the Bottom Line." For a long time now most corporate attention has been focused on the profit-and-loss statement, on earnings per share. But a company can show very nice earnings per share and still go bankrupt. Penn Central is only one example. Chrysler Corp. showed a huge profit in 1976. A mask of profitability can easily be superimposed upon a mess of insolvency.

When the truth is suddenly forced on the public—as it was with W.T. Grant, Penn Central and Chrysler—investors naturally ask: Why couldn't we see this coming before it was upon us? With all the facts and figures churned out by these companies, where was the truth?

The answer is that it was there all along, in the form of cash flow information, but these numbers have been virtually hidden in the attic. Although many bankers, security analysts and company managements have been scrutinizing cash flow information for years, the investors have concentrated primarily on the seemingly all-important earnings per share figure. That's unfortunate. Cash flow analysis can show an investor what a company is really doing—where the cash is coming from and where it is going in inflation-adjusted terms. Most important, it's the only accurate indication of whether a company is growing or—as many of the FORBES 500 currently are—shrinking.

"It's an unfortunate situation that's developed in this country. We've been entirely too earnings-per-share conscious," says Tom Thorsen, chief financial officer of General Electric. "The ball game ultimately is generation of cash."

Harold Williams, chairman of the Securities & Exchange Commission, was even more emphatic: "If I had to make a forced choice between having earnings information and having cash flow information, today I would take the cash flow information."

The simple truth is this: In times of high inflation, earnings figures become less and less meaningful. Why? Mainly because inflation throws depreciation charges—and hence the earnings figures themselves—thoroughly out of line. As the cost of replacing plant and equipment soars in an inflated economy, depreciating historical cost produces less meaningful results, especially for capital-intensive companies.

If borrowing were less traumatic, the problem wouldn't be so painful. In the past, if a company didn't have sufficient internal cash flow it would simply go to the banks for a few million. But with the prime rate around 20%, borrowing money for growth is slow suicide. How many investments have a sure return of better than 20%? Anything less than that is a losing proposition.

Inflation isn't the only problem with earnings figures. Some companies, especially retailers like Sears and J.C. Penney, have millions of dollars in receivables that have been booked as revenues even though no cash came in. Unfortunately, they may not see any cash from those receivables for years. In a severe recession, as a large number of people default on their debts, they may not see the cash at all.

Other companies, like Borg-Warner, Teledyne and Sun Chemical, use another device. They book earnings from firms in which they have equity investments of between 20% and

50% (FORBES, *Mar. 31, 1980*). They never actually get that money. They never actually spend that money. All they do with it is report it. If you want to know how meaningless this is, try claiming as income the proportionate undistributed profits of companies you happen to own stock in. Your share, say, of IBM's undistributed profits, or General Electric's. A banker would throw you out, and with good reason. But companies do it and get away with it.

Even more significant, companies' depreciation schedules vary enormously. Although the trend is toward faster depreciation, there are still a fair number of firms that don't want to punish earnings that way. So, they keep their depreciation nice and slow and earnings nice and high. This is a perfect formula for earnings success if you don't mind rusting plants, inferior R&D and yesterday's technology.

All of this adds up to some rather jarring differences between the picture of a company as seen through earnings analysis and the status of a firm discovered through attention to cash flow.

Take a look, for example, at Dow Chemical and Union Carbide, two giant chemical companies. Over the four years from 1976 to 1979, Dow showed earnings totaling about $2.5 billion. Over the same period, Union Carbide reported cumulative earnings of some $1.8 billion. It would appear that both firms were robust moneymakers in the same league.

But take a step further and look at cash flow. Kidder, Peabody & Co. did this, and although Kidder's methodology is a bit controversial, the question is a matter of degree—not direction. Kidder came up with a number called discretionary cash flow. That's the figure representing how much money a firm has left to grow with—after taking out the amount necessary to maintain its property, plant and equipment and after dividends. Companies don't really set aside money to replace equipment, but ultimately they have to put out that cash—and it's not going toward growth.)

Dow's discretionary cash flow is at a healthy level, with $924 million over the four-year period. But Union Carbide has a different story: negative discretionary cash flow of $663 million. That means, according to Kidder, UC was paying dividends for that whole period of time with borrowed money. It was, in effect, cannibalizing its capital structure to keep the stock price up. That's not a healthy habit. But it's common among the kind of huge firms you'd think would know better. Kidder's list only begins with U.S. Steel, Bethlehem Steel, American Can, Goodyear and Inco.

Union Carbide's comptroller, Louis G. Peloubet, admits that the company was headed in the wrong direction, but claims it has done an about-face. "When I came here five years ago," he says, "the whole emphasis was on the profit-and-loss statement. We moved it from there to the balance sheet and now to cash flow. All our managers are looking at cash flow, both from a liquidity standpoint and from the point of view of capital investment. They didn't even have that information three years ago." True. In fact, Carbide has upped its capital spending 60% over the past three years.

How did big, supposedly well-run businesses ever let themselves get in this kind of a bind?

One of the reasons for ignoring cash flow is that everyone thinks it's something different. The term is used so often that its meaning has been blurred. But, from a technical standpoint, it is derived simply by subtracting the expense of doing business from the cash brought in. It does *not* take depreciation into account. That's because depreciation is only a paper transaction. You can charge off $10 million against your plant this year—but you still have that $10 million to spend anywhere you please.

Cash flow is not simply earnings plus depreciation, however. That's only half the story. Cash flow also takes into account changes in inventories, accounts receivable and accounts payable *(see box, p. 72)*. After all, when money is tied up in inventories, it can't be used to pay bills. So, when inventories go up, cash flow goes down. On the other hand, when a firm has fewer receivables and more payables, it has more cash. And vice versa.

That kind of information can be invaluable in providing early warning signals that something is going wrong in a company. According to James Largay and Clyde Stickney, accounting professors at Lehigh and Dartmouth universities, respectively, in some cases this information can practically hand you a crystal ball. They use W.T. Grant as an example. "The problems that brought Grant into bankruptcy and ultimately liquidation did not develop overnight," they write. "Whereas traditional ratio analysis of Grant's financial statements would not have revealed the existence of many of the company's problems until 1970 or 1971, careful analysis of its cash flows would have revealed impending doom as much as a decade before the collapse."

Hindsight is always 20-20, but the professors are persuasive. Grant's earnings held steady until 1973, when its stock was still selling for as high as 20 times earnings. But its cash flow from operations was in the red as far back as 1966, only surfacing into the black for two years out of the subsequent eight. The company ultimately choked to death on its inventories. Investors who saw that coming were able to get out in time.

Unfortunately, there is a misconception that cash flow need only be used to analyze borderline cases like Grant's. In fact, such analysis can lead to a fuller understanding of any company, no matter how successful or stable.

Look at Savin Corp., the $357 million copy machine manufacturer. Last year the company's earnings were down by $4 million, to $28 million. Only a 12% drop; not bad in a recession, right?

But Savin is a leader in providing cogent cash flow information, and last year that information was of particular interest. Although the red flags that pop up don't point to catastrophe at Savin, they do make the investor aware of potentially significant problems.

The first flag shows up in inventories: up $31 million from 1979. That's $31 million less the company has to spend than it had last year. The reason for the increase is unclear. Maybe

sales are slowing and the firm is overproducing. It could even be a planned buildup for an expected surge in sales. The numbers themselves offer no explanation—but they send you hunting for one.

The next worrisome item is the increase in accounts and royalties receivable: up $34 million. The problem here is fairly clear. People are paying more slowly, preferring to use Savin's money rather than their own. Again, not a catastrophe, but the kind of thing that could really hurt a company if it continues.

Throw in some changes in payables, depreciation and deferred accounts and you come up with net cash flow from operations of $6 million, down from $30 million in 1979. That's a much bigger drop than the drop in reported earnings. Says the firm's senior vice president for finance, Daniel L. Gotthilf, "The question is what happens this year and next year—you can't judge cash flow by any single year or quarter."

Gotthilf is right. What's more, when you look a little farther down the cash flow statement you discover that the firm laid out $51 million for capital expenditures and $21 million for an acquisition. Those are good signs. This is not a company that is putting off investment because times are hard. Still, the problem of receivables and inventories cannot be ignored. Future quarterly reports will have to be carefully scrutinized to make sure the company is taking action.

Even General Electric, widely regarded as one of the best-managed companies around, only recently woke up to cash flow analysis.

According to GE's internally circulated bible on cash flow, written in 1976, "Up until a few years ago, cash planning in the General Electric Co. was pretty much of an unheard art be-

The awful truth

The extent to which major corporations are neglecting their plant and equipment, and paying dividends with cash they don't have, becomes painfully clear by looking at cash flow.

Kidder, Peabody & Co. recently calculated cash flow numbers for 20 of the 30 companies that make up the Dow Jones Industrial Average. Although many people think of cash flow as a simple addition of pretax earnings and depreciation, Kidder goes a giant step further. It recalculates the depreciation figure to take into account the ravages of inflation on historical depreciation schedules.

With this adjustment, 11 of the 20 companies came out of Kidder's computer with *negative* distributable cash flow for 1980. (That's the number showing how much money a firm really has control over, to spend on either growth or dividends.) On a cumulative basis for 1975 to 1979, 8 of these firms showed negative distributable cash flow.

You'd think that companies with negative distributable cash flow wouldn't continue giving dividends. Not so. In fact, the discretionary cash flow figure—distributable cash flow minus dividends—shows that 14 of these firms were paying dividends in 1980 with cash that, by Kidder's hard test, they do not have.

Some firms, of course, may be letting their plants run down deliberately—in effect, liquidating those assets—preparing to move into new, more lucrative businesses. But such decisions in specific cases hardly explain away the broadly negative results of Kidder's calculations.

Company	1980 Net income (est.)	1980 Distributable cash flow	1980 Discretionary cash flow	1975-79 (cumulative total) Net income as reported	1975-79 (cumulative total) Distributable cash flow	1975-79 (cumulative total) Discretionary cash flow	Company
Alcoa	$ 445.0	$ 58.3	$ –57.7	$1,221.1	$ –185.4	$–493.9	Alcoa
American Brands	389.0	184.3	42.1	978.6	495.4	–29.1	American Brands
American Can	95.7	–165.7	–225.5	533.7	–141.6	–390.6	American Can
Bethlehem Steel	95.0	–399.2	–469.2	462.6	–1,660.8	–2,082.0	Bethlehem Steel
Du Pont	670.0	–35.3	–455.3	2,997.6	1,016.1	–517.0	Du Pont
General Electric	1,490.0	852.4	152.4	5,345.8	3,396.6	906.8	General Electric
General Foods	262.0[1]	133.8	23.9	985.1	146.5	–268.8	General Foods
General Motors	–880.0	–4,069.1	–4,947.1	13,894.1	5,393.5	–2,127.6	General Motors
Goodyear	169.0	–488.2	–581.3	861.7	–1,144.4	–1,445.3	Goodyear
Inco	200.0	–86.5	–166.5	646.3	–515.6	–986.6	Inco
IBM	3,500.0	5,390.6	3,390.6	13,229.3	19,500.5	11,972.1	IBM
International Harvester	–397.3[2]	–948.9	–1,030.9	1,085.1	–170.8	–475.1	International Harvester
Johns-Manville	73.2	–51.2	–119.2	430.6	46.5	–140.7	Johns-Manville
Merck	431.0	293.8	113.8	1,451.1	1,056.2	446.2	Merck
Owens-Illinois	127.3	2.8	–40.7	528.0	–16.7	–184.7	Owens-Illinois
Procter & Gamble	642.8[3]	319.5	38.4	2,285.5	1,455.2	425.4	Procter & Gamble
Sears, Roebuck	475.0[4]	–220.6	–649.6	3,786.6	1,272.5	–437.0	Sears, Roebuck
Union Carbide	885.3	–154.4	–360.4	2,158.5	30.8	–819.6	Union Carbide
US Steel	353.0	–1,333.7	–1,472.7	673.4	–4,883.1	–6,622.6	US Steel
United Technologies	390.0	96.4	–79.6	1,030.6	694.1	264.5	United Technologies

Note: All dollar figures in millions. [1]Year ending March 1981. [2]As reported, year ending October 1980. [3]As reported, year ending June 1980. [4]Year ending January 1981.

Source: Kidder, Peabody & Co. Financial Quality Profiles

cause we had a very favorable cash situation. As a result, little long-term planning was done in the company other than in the treasury. We, of course, went through the exercise each year of developing figures for the long-range budget. However, most of the figures were based on some overall predetermined ratio to sales and we never really got into in-depth cash planning."

As a result, the document continued: "GE Co.'s liquidity has declined to a level that could impair its triple-A bond rating."

In 1976 GE launched a massive program in which every corporate officer was forced to pay close attention to every element of cash flow: depreciation, receivables, payables and inventories—everything.

The program has been a smashing success, with the company keeping well over $1 billion in cash that otherwise would have been sitting unproductive in such items as inventories and receivables. When money is wasted like that, it sends a company to the debt market. That's no fun.

But if cash flow is so internally vital to companies—and so externally valuable to investors—why don't we get the information in annual reports? The closest thing we have now is the statement of changes in financial position. But that focuses on an almost meaningless item: working capital. Working capital is of so little use to investors that many accountants have fought to have the statement completely redesigned.

The Financial Accounting Standards Board has recently issued an impressive discussion memorandum on cash flow and liquidity that addresses many of these problems. As a discussion draft it makes no proposals, but rather suggests possibilities for disclosure to investors. Still, the FASB's message is clear: Cash flow information is necessary. Unfortunately, as with all FASB projects, it could be several years before we'll see this reflected in annual reports. But the demand for the information may be irresistible. A recent FASB survey of 415 executives, analysts and academics revealed that 67% thought cash flow information was "highly important"—while no more than 49% said the same thing about earnings per share.

As a first step, the SEC has required that 1980 annual reports include a discussion by management of any unusual cash flow problems, and of the steps being taken to remedy them. As for the possibility of anything more concrete in the near future, Williams pointed out the problems the SEC had getting disclosure of inflation-adjusted earnings numbers. "The corporate community didn't like it because they wouldn't look as good, and the accountants didn't like it because it wasn't measurable and might get them into areas that they were uncomfortable with. I expect that the problems will be similar."

The truth is we are simply relearning lessons of the past. "The Romans only knew about cash flow," says Fred Tepperman of Arthur Young & Co. "But then we got sophisticated, learned about accrual and forgot about cash." He's not knocking accrual, he's only saying it's not the same as cash. (One of our more colorful captains of industry puts it slightly differently. "There are," he quips, "two kinds of money, cash and the other kind. I'll take cash every time.")

According to Loyd Heath, a professor of accounting at the University of Washington and the author of a much-praised 1978 monograph on liquidity, "In the early part of this century, accountants were very concerned with cash flow—with the needs of short-term creditors. But beginning in the 1930s, with the passage of the Securities Acts, the accountants began to shift their attention away from this. There was a sort of backlash. They didn't want to be dictated to by the commercial banks or short-term creditors. They had found a new interest in earnings. And they not only de-emphasized cash flow, but they seemed to completely ignore it.

"It's not that cash flow is new to accountants," says Heath.

Cash flow made easy

How do you figure out cash flow information for a nonfinancial company using today's annual reports? Here's one simple but effective way:

Start with the annual report's statement of changes in financial position. There, hidden near the top, you'll find a line labeled something like "working capital provided by operations."

Unfortunately, that working capital figure doesn't take into account any changes in receivables, payables or inventories—all of which affect cash flow. So you've got to throw them in yourself. Look further down on the financial position statement for a section called "changes in working capital." If receivables or inventories have *decreased* from the preceding year—thus freeing up more cash—*add* the amount they've changed to the working capital number. If they've *increased*, that means less cash, and you *subtract* the change from working capital.

With accounts payable, things work just the other way around. More payables means the company is holding on to more cash. So add any increase in payables, or subtract any decrease. You're almost home now, with a figure called "cash flow from operations."

What does this number tell you? Well, for one thing, any dramatic change in receivables, payables or inventories is worth looking into. For another, check to see how the cash flow from operations figure has moved in relation to income and working capital over the past few years. If cash flow has consistently been much lower than either, get ready to call your broker—there may be trouble.

Now comes the interesting part: figuring out where that money is going, or where it *should* be going. There are three possibilities. The company could be using the money to grow, to maintain the status quo or to pay dividends.

To get an estimate of how much the company should be spending just to keep current operations going, try the back of the annual report in the section with inflation-adjusted results. There you'll find a depreciation figure adjusted for the current cost of replacing the company's assets. Of course, companies don't just keep replacing what they've got: They let old businesses die out, or improve them with technology changes that save money or switch businesses altogether. One thing's for sure, though: The depreciation figure the company uses on its income statement is a hopeless understatement, and in the absence of more information the inflation-adjusted number is your best bet.

Subtracting the new depreciation figure from operating cash flow yields distributable cash flow—the amount the company has in hand to pay dividends or invest in real growth. If distributable cash flow is negative, there's cause to worry. There's also reason to raise an eyebrow if distributable cash flow is positive and the company pays more than that in dividends. It's nice to be generous to investors, but not by liquidating your company.

Of course a firm can always try to make up for a cash flow shortage by borrowing. But except in a high-return industry like electronics, do you really want to invest in a company that's financing growth with 20% money?

Remember that cash flow analysis is most useful if you go back and look at several years running. Any company can have negative cash flow for a year or two without permanent damage, and capital investment problems don't develop overnight. Nevertheless, enough companies have been caught napping in the last decade to make anyone a little jumpy.—Thomas Baker

"They should have seen it all along, but they were blinded because they thought the measurement of earnings was the beginning and the end, the alpha and omega of accounting."

But you can't ignore the rain when it's pouring through your roof, and the destructive inflation of recent years has forced accountants to take note. However, on their way to presenting some kind of unified cash flow information, they have run into a crucial question: How do you determine how much money a company needs to maintain its plant and equipment, without any growth? You need to answer this question before you can come up with a distributable (or "free") cash flow figure—the figure that tells you how much money the company *really* has control over to spend on dividends or growth.

This is a slippery one. Companies are constantly expanding and contracting operations in response to market conditions. What's more, new technology can slash a company's cost of upgrading its assets. So pinning down the exact point at which maintenance—or need for maintenance—ends and growth begins can be nearly impossible.

The FASB offers one solution in its Statement 33, which adjusts earnings for inflation. They recalculate depreciation using replacement costs rather than historical costs. That's probably the best figure at the disposal of the average investor.

However, Barre Littel and Robert Levine, the analysts who developed Kidder, Peabody's cash flow system, argue that the FASB numbers can understate the amount it costs to keep plant and equipment up to snuff. Here's why: Let's say a firm has two factories. One is depreciated at $1 million a year. The other is fully depreciated. The company needs both plants to continue in business. Under the FASB's system, the plant depreciated at $1 million a year would be assigned a new depreciation figure to account for inflation. However, the plant that was fully off the books could stay off the books. Kidder's analysts say that plant, too, should be assigned a new depreciation figure. It makes sense. It's precisely those old, fully depreciated plants that are most in need of replacement—at a cost much greater than their historical costs.

The numbers Kidder has come up with make much of U.S. industry look shaky *(see table, p. 71)*. While some critics argue that Kidder has gone too far and made things look worse than they are, even if Kidder is near the truth, that's reason to examine your investment portfolio carefully.

When you see companies like GM, Sears, International Harvester and Du Pont with negative cash flows, it's time to reevaluate the way you look at all companies. Especially with the market turning back to blue chips, the time is now for investors to look at these cash flow figures.

Emphasizing earnings while ignoring cash flow actually rewards companies for putting off needed capital investment. The smaller the depreciation charge, the higher the earnings. In turn, higher earnings produce better stock prices. Finally, the stock price is often reflected in a fatter paycheck for the CEO. Is that one important reason for the notoriously low level of capital spending in the U.S.? CEOs are only human.

Of course, total reliance on cash flow information could be equally dangerous. Any capital investment turns cash into plant and hurts cash flow in the short term. Cash flow figures are only valuable when looked at over a number of quarters or years. As Bryan Carsberg, an FASB expert on cash flow, says, "Asking which one is better, cash flow or earnings, is like asking which you should cut out, your heart or your lungs."

Ideally, investors will start looking at—and annuals will start showing—earnings information and cash flow information side by side. The earnings information will show how well the company is doing at making money. The cash flow information will show how real that money is.

A vice president of a major international bank wrinkles his forehead and strokes his jaw as he says, "Sure, cash flow information will be here in a relatively few years. What worries me is how many companies will have gone under by then." ■

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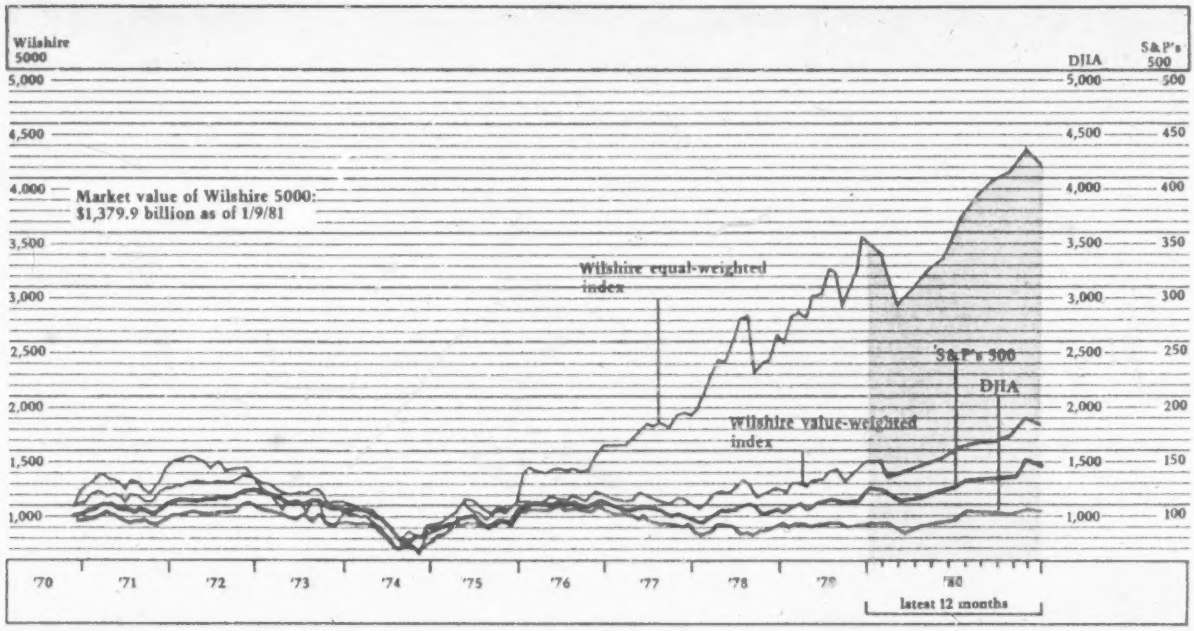
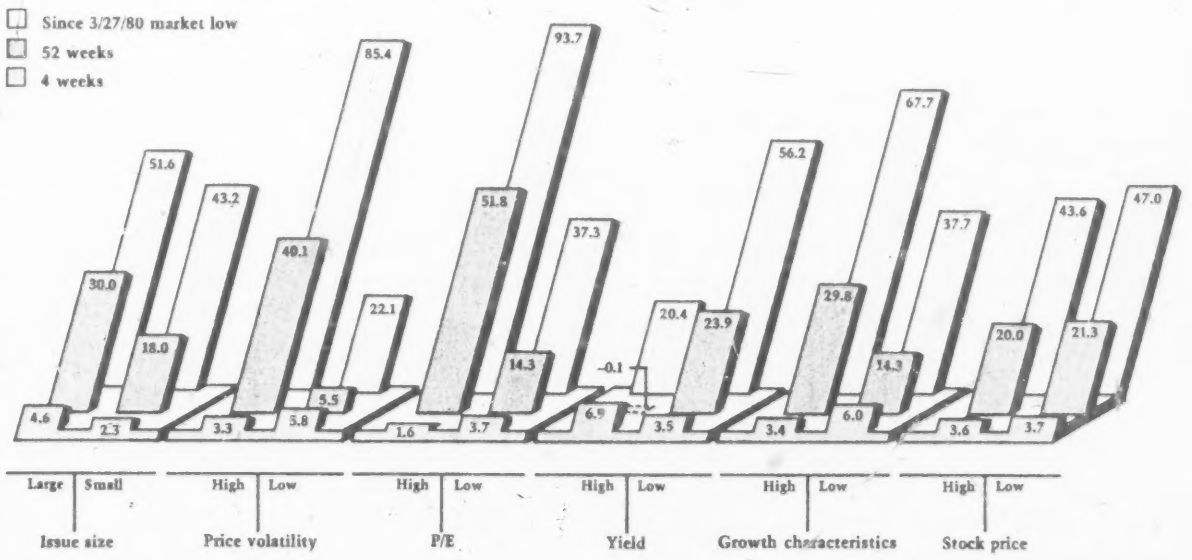
The Forbes/Wilshire 5000 Market Review



Market Focus

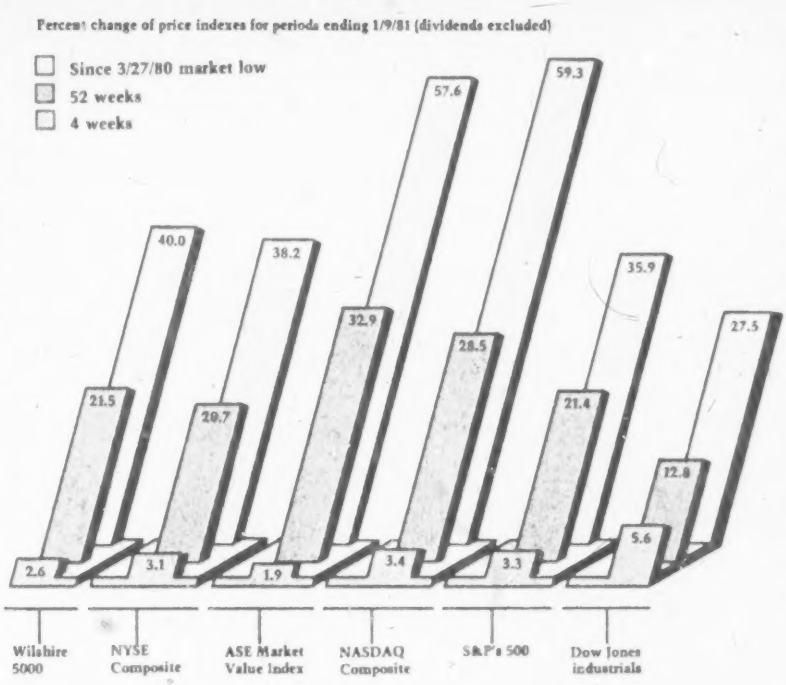
Not surprisingly, these charts minimize the importance of Wall Street's early January gyrations. Like most broad indicators, the Forbes/Wilshire Index peaked in November. "What happened at the beginning of the year was more a last fling for the Dow than a fundamental show of market strength or weakness," says Smith Barney's timing strategist Allan Shaw. "People are pulling gains out of oil stocks, and they need a place for their money." As the Focus figures make clear, the momentary winners are low-P/E, low-growth companies—holdings that missed the spectacular 1980 rise. Their gains might merely mean that skittish investors are parking funds where risk is least. On the other hand, they may instead be a healthy signal of leadership from a new sector.

Percent change of equal-weighted price indexes for periods ending 1/9/81 (dividends excluded)



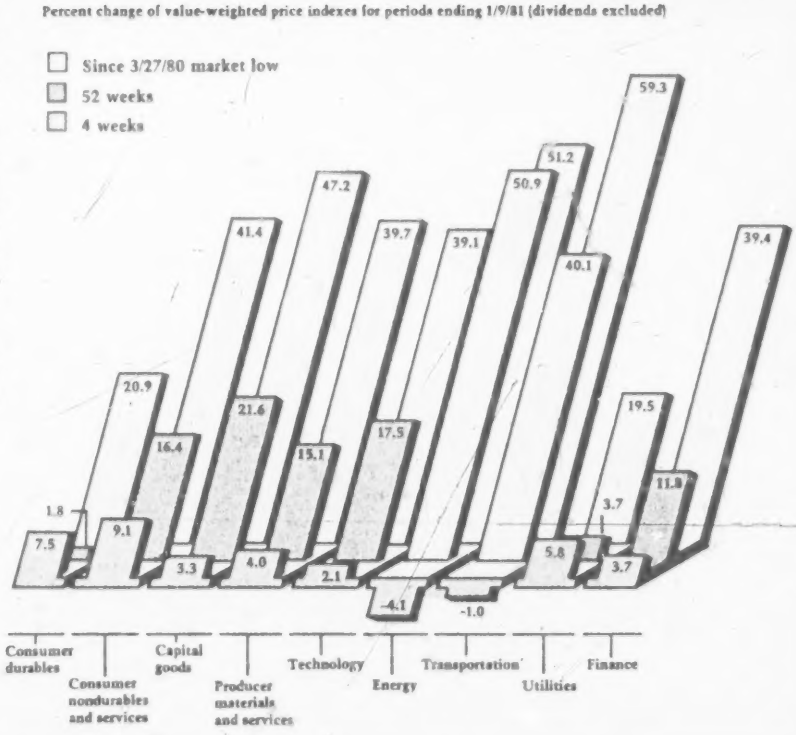
Market Returns

These Market Return results may surprise readers who lost big early in January. For the trailing four-week period, all indexes are up smartly, and the Dow leads the pack. The energy-dominated Amex showed the slimmest gain—another mark of profit-taking in last year's winners—though it still sports the best annual performance with an overall 33% increase. As the Wilshire numbers show, the broad market is up more than 20% in 12 months. These figures, however, are capital-weighted, and were influenced less by scores of pace-setting small companies than a few lackluster big ones. A dartboard investor would probably have done even better.



Sector Returns

If the market is searching for new leadership, the Sector Return charts show clearly where it might be found. In the past four weeks, stocks in consumer-related companies scored impressive gains. Nondurable producers like Procter & Gamble and Sears, Roebuck, in fact, posted average price increases of over 9% and durables companies did nearly as well. Interest-sensitive utilities zoomed ahead, too, in response to the anticipated peak in the cost of money. This is a clear reversal of previous trends. Stocks that did well last year, such as energy issues, are faring poorly now; stocks that lagged the 1980 averages are now setting the pace.



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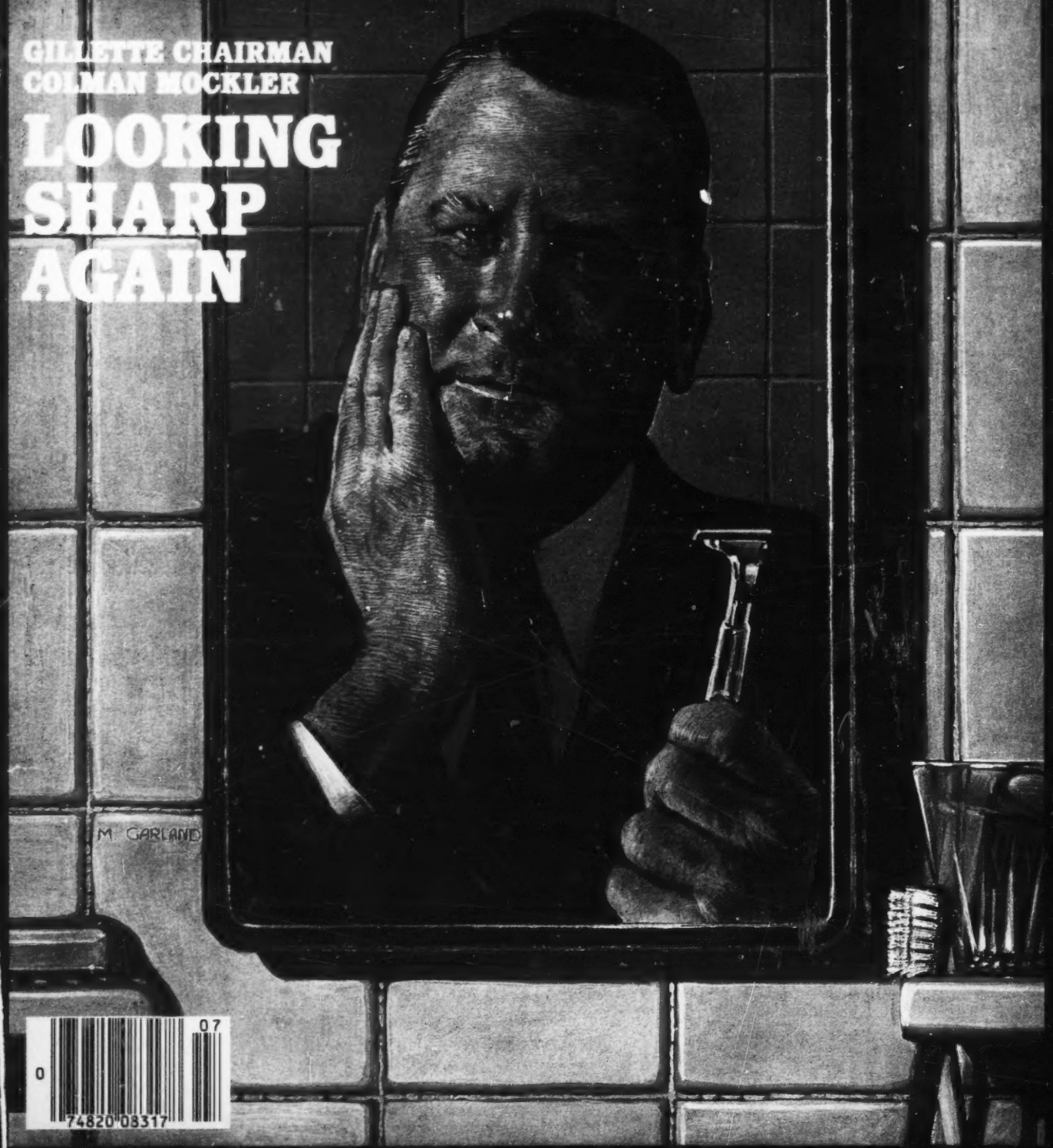
GILLETTE CHAIRMAN
COLMAN MOCKLER

LOOKING SHARP AGAIN



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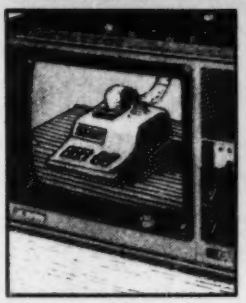

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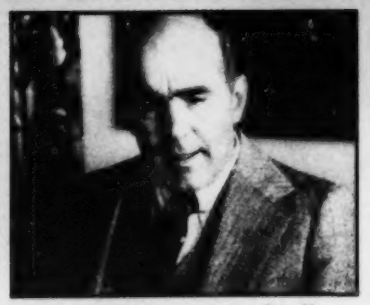

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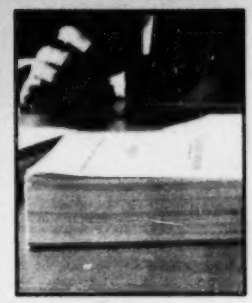

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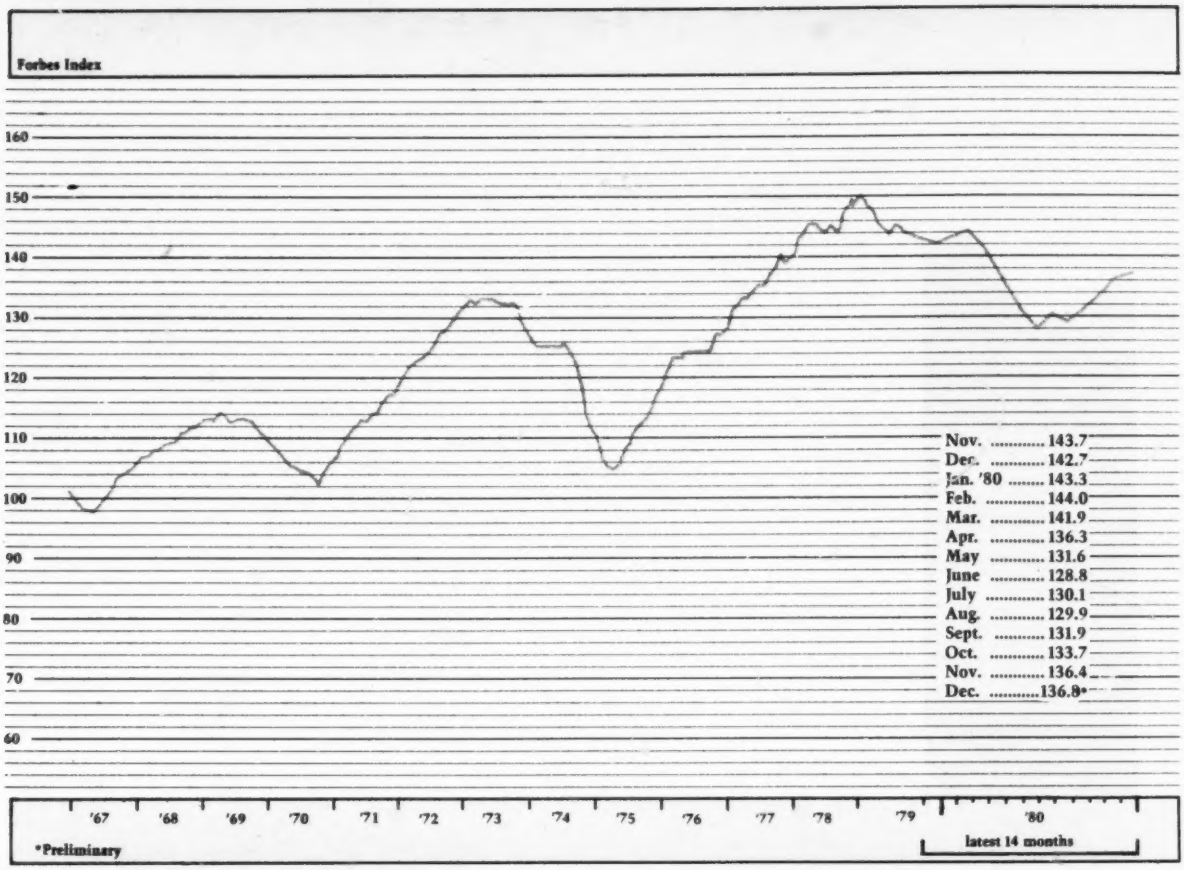
The Forbes Index



Nov.	143.7
Dec.	142.7
Jan. '80	143.3
Feb.	144.0
Mar.	141.9
Apr.	136.3
May	131.6
June	128.8
July	130.1
Aug.	129.9
Sept.	131.9
Oct.	133.7
Nov.	136.4
Dec.	136.8*

The Forbes Index Components

The economy is still heading up— but the pace is clearly slowing. In the current reporting period, gains in industrial production and personal income were well below previous levels. Retail sales, on the other hand, are actually falling. The December figures were off sharply. Housing starts are in the doldrums, too—back to the dismal numbers of last spring.

The FORBES Index is a measure of U.S. economic activity composed of eight equally weighted elements:

Total industrial production

New claims for unemployment compensation

The cost of services relative to all consumer prices

The level of new orders for durable goods compared with manufacturers' inventories

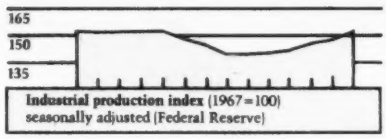
Total retail sales

New housing starts

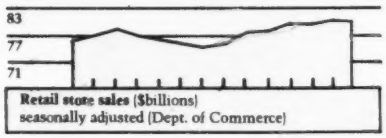
Personal income

The change in the amount of consumer installment debt outstanding

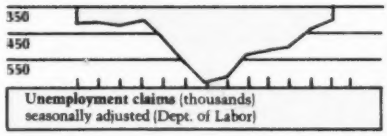
To measure these eight elements, FORBES monitors 11 series of U.S. government data. The last 14 months' data for each series is presented at right.



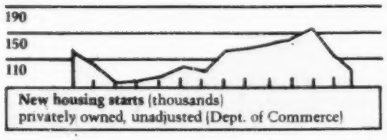
Industrial production index (1967=100) seasonally adjusted (Federal Reserve)



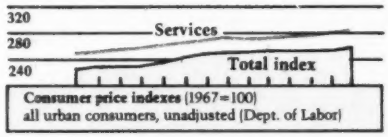
Retail store sales ($billions) seasonally adjusted (Dept. of Commerce)



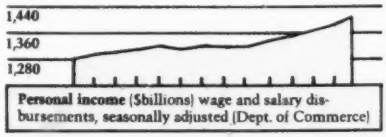
Unemployment claims (thousands) seasonally adjusted (Dept. of Labor)



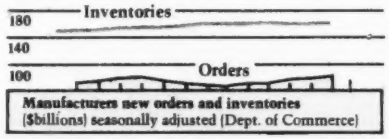
New housing starts (thousands) privately owned, unadjusted (Dept. of Commerce)



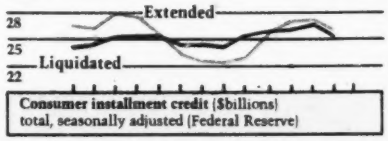
Consumer price indexes (1967=100) all urban consumers, unadjusted (Dept. of Labor)



Personal income ($billions) wage and salary disbursements, seasonally adjusted (Dept. of Commerce)

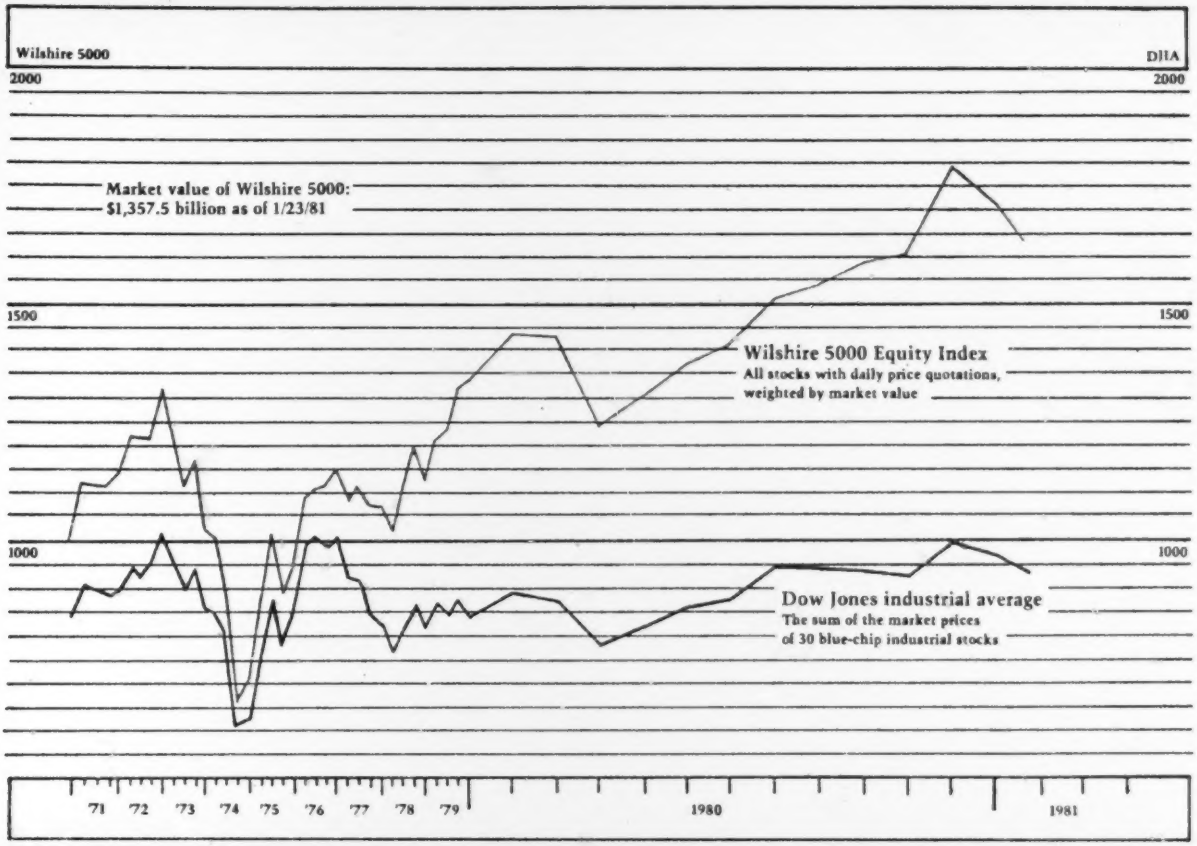


Manufacturers new orders and inventories ($billions) seasonally adjusted (Dept. of Commerce)



Consumer installment credit ($billions) total, seasonally adjusted (Federal Reserve)

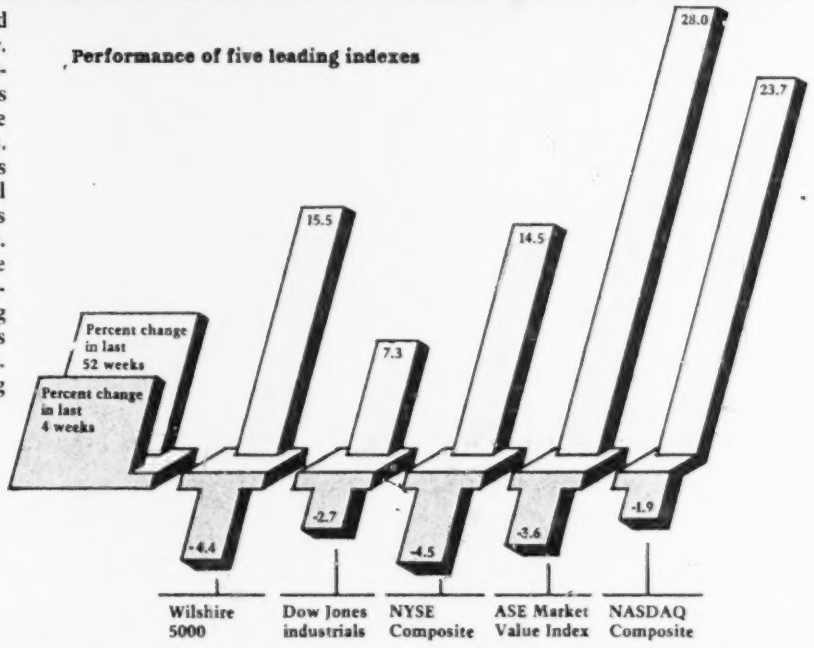
The Forbes/Wilshire 5000 Review



Close-up On The Equity Markets

This reporting period wasn't a good one for any of the indexes we follow. What's more—as the graph above indicates—the broad-based Wilshire has trended down more steeply than the Dow since November's market highs. Despite that 97-year-old indicator's imperfect measurement of overall stock performance, this time there's no silver lining behind its clouds. Look hard, however, and there may be some cheery news among all the negative numbers: The once-high-flying NASDAQ is weathering Wall Street's midwinter chill surprisingly well. Could that be a harbinger of a strong spring for over-the-counter shares?

Performance of five leading indexes

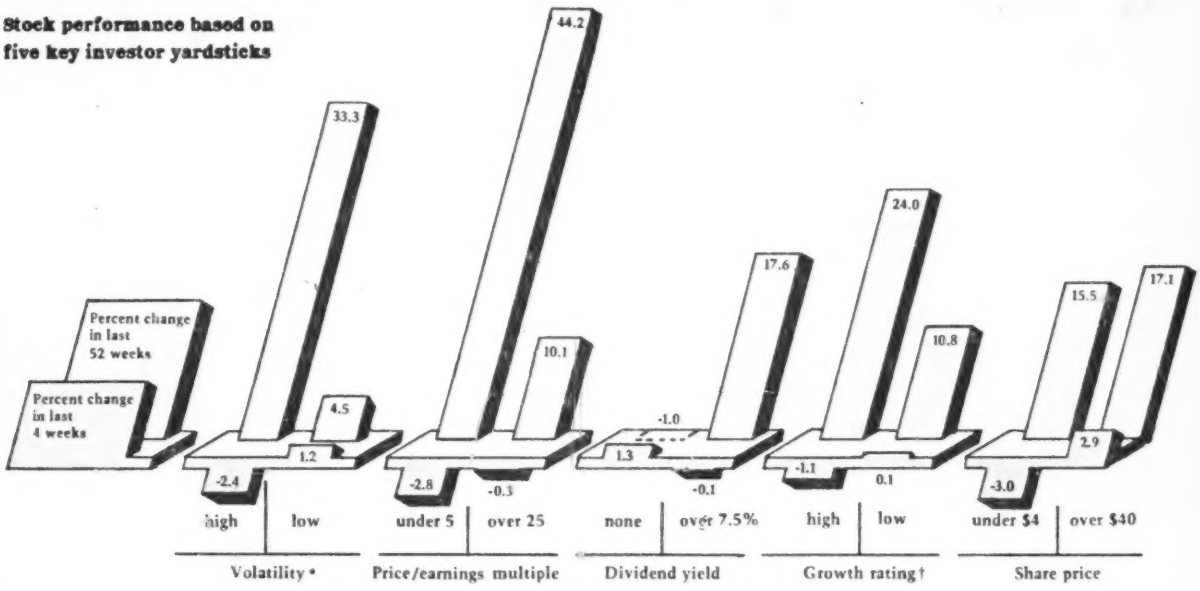


Note: All data for periods ending 1/23/81. Prepared by Wilshire Associates, Santa Monica, Calif.

Where The Action Is

The market is still correcting last year's excesses. Low P/E issues and other stocks that sport huge 52-week gains are now posting the sharpest four-week declines. What's more, the search for new leadership is still on. The few equity groups that increased in value during the current reporting period, such as low volatility, high-priced shares, moved up only marginally— giving no real hint of what kinds of investments should do well in 1981.

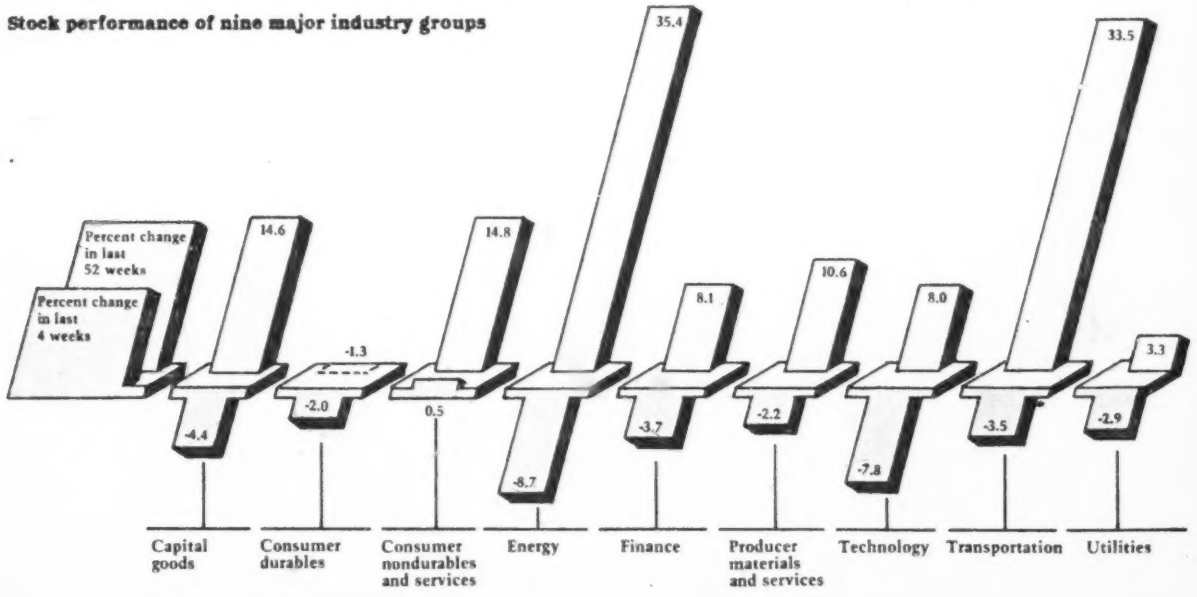
Stock performance based on five key investor yardsticks



* A stock's sensitivity to overall market movement. High volatility issues have wide price fluctuations; low volatility issues are more stable.
† An evaluation of a stock's earnings growth based on a Wilshire Associates mathematical model.

The overriding trend here is the continuing decline in energy stocks, now nearly matched by technology-related companies. The latter's four-week decline comes close to offsetting the preceding 52-week gain. One inkling of future strength is the current relatively good showing of consumer-related issues. These stocks missed last year's boom—and some Wall Street professionals think they may benefit first when the economy begins to recover.

Stock performance of nine major industry groups



Note: All data for periods ending 1/23/81. Prepared by Wilshire Associates, Santa Monica, Calif.

Many deeply discounted, top-grade corporate bonds now offer high yields and a shot at large, long-term capital gains.

Good and cheap

By Steve Kichen

ARE YOU AN OPTIMIST who thinks interest rates have finally peaked? Do you believe Reagan will be able to cut government spending and taxes without triggering another, even more severe bout of inflation? Then you may find top-grade, deeply discounted corporate bonds awfully tempting.

Jim Kochan, vice president, fixed income research, Merrill Lynch, is one optimist. "There are signs the economy is weakening and a significant decline in short-term rates is in the making. We're looking for positive proof of a significant slowing in monetary growth."

When deeply discounted AA and AAA bonds provide yields to maturity in the teens only the more venturesome need dabble with riskier lower-quality bonds.

Take the AAA New York Telephone bond maturing in 1989. Back in 1954, when this bond was issued, its 3% coupon was right in line with the market. With today's prime hovering close to 20% and inflation in double-digits, the market has discounted the bond to $538. So the $30-a-year (or 3%) interest on the $1,000 face value represents a current yield of 5.6% on the market price of $538. The yield to maturity on the bond is only 11.5%, but as the bond appreciation is taxed as a capital gain rather than ordinary income, it's worth more to those in the high tax brackets.

Statistical Spotlight

The real appeal of deeply discounted bonds is their response to interest rates. When rates decline, they appreciate more than others. With a 1% decline in yield, for example, a 7½% coupon 2011 Ohio Bell Telephone bond would appreciate from $594 to $645, a gain of $51, or 8.6%. A 12⅝% coupon 2020 Ohio Bell would appreciate from $936 to $1,010—a gain of $74, or 7.9%. If the bonds were bought on margin, the appreciation spread would be greater.

Some well-known economists have recently issued forecasts for higher, not lower, rates over the short term. However, some decline in interest rates seems likely at some point before the end of the decade. To dispute the possibility that a significant dip in interest rates could occur would be to write off all prospect of economic recovery for the next nine years. With declining interest rates, today's deeply discounted bonds could be sold before maturity with fairly decent capital gain.

Most of the bonds in the table are closer to their 52-week lows than highs. While most bond bulls don't anticipate a replay of spring 1980, when the market soared as interest rates collapsed, many feel a significant bond rally is in the offing. As any pessimist would be quick to note, there are no guarantees, and taking a margin plunge into deep-discount bonds could be courting a margin call if rates climb. If the optimists are right, these bargains may not last.

High-quality bonds at bargain prices

The table below contains 45 AA and AAA corporate bonds "bargain priced" at less than $645. Since many companies have several discounted bond issues, we selected only one or two representative bonds—mostly those with the greatest discount or greatest price change over the last 52 weeks. Each bond also has at least $50 million outstanding.

Company[1]	Coupon %	Maturity	S&P's rating	Recent price	Current yield	52-week price range	% change from low to high	Interest coverage
American Cyanamid	7⅜%	2001	AA	$620	11.9%	$770-563	37%	3.68
American Tel & Tel	3⅞	1990	AAA	570	6.8	764-523	46	2.89
Bell Telephone of Pennsylvania	7⅛	2012	AAA	585	12.2	759-520	46	2.98
Beneficial Corp	8.4	2007	AA	628	13.4	784-580	35	1.32
Caterpillar Tractor	5.3	1992	AA	600	8.8	710-535	33	4.42
Chesapeake & Potomac Tel, Va	7¼	2012	AAA	563	12.9	715-540	32	3.05
Chesapeake & Potomac Tel, DC	7¾	2013	AAA	601	12.9	958-550	74	3.34
Chesapeake & Potomac Tel, W Va	7¼	2013	AAA	551	13.2	710-511	39	2.83
Cleveland Electric Illumination	8⅜	2011	AA	615	13.6	780-570	37	2.63
Corn Products (CPC Intl)	5¾	1992	AA	558	10.3	700-523	34	4.72
Exxon	6	1997	AAA	599	10.0	725-535	36	9.33
General Electric	5.3	1992	AAA	616	8.6	720-560	29	6.56
General Motors Acceptance	8	2007	AAA	630	12.7	809-561	44	1.10
Household Finance	8½	2001	AA	634	13.4	828-574	44	1.23
Illinois Bell Telephone	7⅝	2006	AAA	638	12.0	800-551	45	3.10
Manufacturers Hanover	8⅛	2007	AAA	621	13.1	810-576	41	1.08
Michigan Bell Telephone	7¾	2011	AAA	610	12.7	780-400	95	2.87
Mobil Oil (Mobil Corp)	7⅜	2001	AAA	620	11.9	800-581	38	5.37
Mountain States Tel & Tel	8	2017	AAA	628	12.7	804-561	43	2.77
New Jersey Bell Telephone	7⅜	2012	AAA	581	12.7	770-533	44	3.89

[1]"Company" refers to name of issuer. If name has been changed or a different company controls the bond, that name appears in parentheses after company name.
[2]Bond traded on the American Stock Exchange. All other bonds traded on the New York Stock Exchange.

Sources: The Media General Financial Weekly; *Standard & Poor's*; FORBES

Company[1]	Coupon %	Maturity	S&P's rating	Recent price	Current yield	52-week price range	% change from low to high	Interest coverage
New York Telephone	7⅛%	2011	AAA	$591	12.5%	$749-516	45%	3.05
New York Telephone	3	1989	AAA	538	5.6	640-506	26	3.05
Northwestern Bell	7½	2005	AAA	615	12.2	756-538	41	3.31
Ohio Bell Telephone Co	7½	2011	AAA	594	12.8	750-531	41	3.30
Pacific Gas & Electric	8½	2009	AA	640	13.3	825-554	49	2.69
Phillips Petroleum	7⅜	2001	AA	641	11.9	806-610	32	10.23
Public Service of Indiana	7	2002	AA	580	12.1	700-481	46	3.48
Sears, Roebuck	6¾	1993	AA	630	10.1	765-534	43	1.85
Shell Oil	5.3	1992	AA	575	9.2	710-536	32	9.31
Sinclair Oil (Atlantic Richfield)	4.6	1988	AA	610	7.5	719-594	21	4.48
Socony Mobil Oil (Mobil Corp)	4¼	1993	AAA	558	7.6	614-470	31	8.56
South Central Bell Tel	7⅜	2007	AAA	620	11.9	740-535	38	3.01
Southern Bell Tel & Tel	7⅜	2013	AAA	606	12.6	788-544	45	3.26
Southern California Edison[2]	8¼	2002	AA	616	13.4	773-550	41	2.94
Southern New England Tel	8⅛	2008	AA	620	13.1	780-565	38	2.65
Southern Railway (NWS Enterprises)	5	1994	AA	550	9.1	610-520	17	3.35
Southwestern Bell Telephone	6⅞	2011	AAA	580	11.9	738-518	42	2.66
Standard Oil of California	5¾	1992	AAA	621	9.3	751-531	41	12.44
Standard Oil, Indiana	6	1998	AAA	561	10.7	720-515	40	7.22
Texaco	5¾	1997	AA	580	9.9	680-515	32	6.25
Union Oil of California	6⅝	1998	AA	560	11.8	731-550	33	6.05
US Gypsum Co	7⅞	2004	AA	605	13.0	850-543	57	10.46
United Technologies	4½	1992	AA	500	9.0	575-440	31	3.47
Utah Power & Light	8¼	2007	AA	615	13.4	800-590	36	2.14
Wisconsin Telephone Co	8	2014	AAA	635	12.6	824-556	48	3.21

[1] "Company" refers to name of issuer. If name has been changed or a different company controls the bond, that name appears in parentheses after company name.
[2] Bond traded on the American Stock Exchange. All other bonds traded on the New York Stock Exchange.
Sources: The Media General Financial Weekly; *Standard & Poor's; FORBES.*

Statistical Spotlight

Spinning off a subsidiary can often produce tasty profits for lucky stockholders.

Investing in deconglomerates

By Maurice Barnfather and Steve Kichen

CHAIRMAN VINCENT BELL of $100 million (sales) Safeguard Business Systems puts it like this: "The spinoff gave us a sense of our own destiny, visibility as a public vehicle. It lifted morale." Last year's spinoff of SBS (FORBES, *Nov. 26, 1979*) by the then $135 million (sales) Safeguard Industries did something else according to Bell: "Our value to shareholders increased. They could see our success, measure it clearly and buy stock in it."

No one can argue with that; $1,000 invested in Safeguard Business Systems last March would now be worth $1,323. Most other spinoffs during the past decade have had an even more wallet-warming effect *(see table)*. There have been dogs, of course: the recent spinoff of ailing Interstate Motor Freight by Fuqua Industries, for example. WICOR is up only 6.4% since its spinoff in June 1975. But on the 20-stock list where the parent spun off all but perhaps a few percent of the stock in each case, there's an impressive 285% average gain.

The spinoff idea is not new. Spinoffs occur when a parent company sets up one of its subsidiaries as a separate entity and distributes shares in it to existing shareholders of the parent. Back in 1968 FORBES reviewed 15 years of spinoffs. We revisited the subject Mar. 19, 1979. The message each time: Shares of spunoff companies rise significantly faster than those of the parent. That's to be expected since spinoffs are usually candidates for divestiture because they're growing faster than their parent.

The number of spinoffs is almost certain to increase. "The 1980s will be the 'deconglomerating' era," says Oppenheimer & Co., Inc. Executive Vice President Nathan Gantcher.

If the proposed spinoff is so profitable, why hand it to someone else? Spinoffs show the sum of the parts to be worth more than the whole. Managers are usually shareholders too. Gantcher: "If you've got a piece of paper worth $20, you could have two pieces worth $40 after a spinoff."

There are other reasons to divest, of course. A company might want to concentrate on other parts of its business that may be larger but not as profitable. Says Oppenheimer's Ellen Greenspan: "Jewels can be small relative to the rest of a parent company's business." Margins at Mead Corp.'s Mead Data Control, for example, are higher than the parent's, but total sales of Data Control are less than 1% of Mead's sales.

Says John A. Wilson, chairman, president and CEO of Color Tile, which was spun off in 1979 by Tandycrafts, itself spun off from Tandy Corp., in 1975: "Getting businesses down to pure-play operations is better for management and stockholders. Concentrate on the growth

company and everyone does better." Color Tile's shares are up almost 60% since the spinoff.

Tandycrafts' Chairman and President G.R. Nugent agrees: "We weren't growing much. But once our cash cow Color Tile was spun off, we took a look and fixed up what was left. We might never have seen it otherwise." Fortunately he did. Since 1975 a share of Tandycrafts is up 269%, after two subsequent spinoffs.

Another winner, spun off by Gearhart Industries, is Pengo Industries, up 288% since 1978. Says President and Chairman Harold Owen: "We're doing better since the spinoff largely because of acquisitions, which is something we could do only as an independent."

That, says Oppenheimer's Arthur Ainsberg, is crucial: "If your stock is 4 times earnings and you get spun off as a division growing 25% a year and take a 15 multiple in The Street, it's much easier to acquire for stock."

Not everybody, however, is a winner in the spinoff game. For one thing, not all announced spinoffs take place. If you bought General Tire & Rubber in 1976 at $25 awaiting divestiture of then $230 million (sales) RKO General, you would still be waiting and nursing a 16% loss.

On balance, however, the record suggests that investing in new spinoffs has a better-than-even chance of success. In the second table are some companies that may be contemplating spinoffs. But if the number of spinoffs increases sharply as expected, so will the risks as the bad begin sneaking to market under cover of the good.

Spinoff superstars

Had you invested $1,000 in each of these 20 companies at the time they were spun off, your portfolio would now be worth over $77,000—a 285% increase.

Spunoff company (Parent)	Spinoff date	—Market price— spinoff date	recent	Recent value of $1,000 invested in spinoff	% change
Safeguard Business Sys (Safeguard Ind)	3/04/80	24	31¾	$ 1,323	32.3%
Valero (Coastal Corp)	12/31/79	11	33½	3,045	204.5
Mesa Royalty Tr (Mesa Petrol)	11/19/79	30¼	37½	1,240	24.0
Leasco (Reliance Group)	5/14/79	14¼	40	2,807	180.7
Color Tile (Tandycrafts)	4/09/79	11¾	18½	1,574	57.4
Pengo Ind (Gearhart Ind)	6/20/78	6¼	24¼	3,880	288.0
Cole Consumer Prod (Cole Natl)	3/23/78	3½	11¼[1]	3,214	221.4
Lanier Business Prod (Oxford Ind)	7/01/77	11¾	36⅝	3,117	211.7
Cronus Ind (Tyler Corp)	4/15/77	3½	5¾	1,643	64.3
Scriptomatic (Refac Tech Develop)	1/03/77	3	16¼[2]	5,417	441.7
Consol Fibres (Browning-Ferris Ind)	10/18/76	2⅝	10⅜	3,952	295.2
American Credit (Wachovia)	7/01/76	14⅛	50 [3]	3,540	254.0
Stafford Lowdon (Tandycrafts)	5/14/76	6¾	26¾[4]	3,963	296.3
Tandycrafts (Tandy Corp)	11/28/75	14⅛	52⅛[5]	3,690	269.0
Tandy Brands (Tandy Corp)	11/28/75	2½	22⅜	8,950	795.0
WICOR (American Natural Resources)	7/14/75	17½	18⅝	1,064	6.4
Northwest Energy (El Paso Co)	5/01/74	5⅜	27	5,023	402.3
United Energy Resources (Pennzoil)	4/16/74	3	44	14,667	1,366.7
Louisiana Pacific (Georgia Pacific)	1/19/73	11⅞	24¼	2,042	104.2
Viacom Intl (CBS)	6/04/71	18¼	52⅜	2,884	188.4

[1]Acquired by Shelter Resources for $11.25 per share. [2]Acquired by British Electric for $16.25 per share. [3]Acquired by Barclays Bank International for $50 per share. [4]Acquired by American Standard for $26.75 per share. [5]Recent price of Tandycrafts includes value of 1.00 share of Color Tile and 0.25 share of Stafford Lowdon, which were both spun off.

Sources: "The Sum of the Parts," *Oppenheimer & Co; FORBES.*

Spinoff possibilities?

If the stock market loves energy and high-technology stocks, then perhaps it will love spinoffs in those two industries, too. Here are nine companies with subsidiaries in these hot industries that are separate from the parent company's main product line. Sales and earnings figures for the subsidiaries are mostly estimates because only a few of the companies would release actual figures.

Company possible spinoff	Principal business	Recent price	Price/ earnings ratio	Latest 12 months sales (millions)	earnings (millions)	earnings per share
Cabot Corp	**chemicals, energy, engineered products**	28⅞	5.9	$1,404	$153	$4.88
energy group	explor, dev and prod of oil and gas			399	52	1.64
Control Data	**computer equipment and services**	65	8.4	2,670	132	7.77
Service Bureau Corp	computer services			230	13	1.73
WR Grace	**chems, natural resources, consumer prods**	53¾	8.9	5,873	282	6.07
natural resources division	oil and gas			690	108	2.31
Mead Corp	**paper products**	25⅞	5.1	2,647	135	5.10
Mead Data Central	electronic information services			20	7	0.27
Mountain Fuel Supply	**natural gas utility**	44½	10.2	391	32	4.38
Wexpro	oil and gas explor and prod			50	11	1.46
Norlin	**musical instruments, beer, electronics**	14¼	NM	275	d2	d0.80
technology group	electronics			58	4	4.78
Quaker Oats	**food processing**	30⅜	6.8	2,473	95	4.48
Fisher-Price Toys	toys			380	34	1.68
Warner Communications	**movies, records, television programs**	37⅜	9.5	1,873	218	3.95
Atari, Inc	electronic games and microcomputers			400	48	0.87
Westburne Intl Industries	**plumbing equipment, energy**	22¼	5.1	918	34	4.40
Westburne Petroleum Serv	oil and gas drill and explor, oil field equip			183	12	1.75

d: deficit. NM: not meaningful.

NOTE

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